ALCHEMY OF FINANCE IN PRACTICE: HOW TO REPLICATE MULTI-STRATEGY HEDGE FUNDS

3 March 2024

Investment Perspectives

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Alchemy of Finance in Practice: How to Replicate Multi-Strategy Hedge Funds

Alex Gavrish is founder of Etalon Capital Ltd and author of the book "Investing: From Science To Art"

According to PivotalPath, its index of multi-strategy hedge funds gained only 5.4% percent in 2023. S&P 500 Index rose 26%, S&P 500 Equal-Weight Index rose 14%, and the NASDAQ-100 Index climbed 55%. As of beginning of March 2024, the risk-free rate of three-month Treasury bills is above 5%.

Aurum's index of multi-strategy hedge funds provided a 10-year annualized net return of 7.7%. Aurum reported that total hedge fund industry assets are $2.9 trillion, with 184 multi-strategy hedge funds managing $417 billion of this total.

I personally find this performance not especially attractive, given the fact that many hedge funds use leverage, and so a return of say 8% percent with x2 times leverage is actually only a 4% return on unleveraged funds.

There are probably certain reasons why investors are being attracted to those funds, with some of the main one's being the risk management and control practices of these firms as well as access to many portfolio managers and therefore the ability to deploy capital quickly in strategies that offer the best opportunities in a given market environment. But it is not the objective of this article to discuss these issues.

However reasonable and persuasive the logic and possible benefits of investing in these funds sound, investors, first and foremost, should ask themselves what is attractive in a 8% return when risk-free rate is 5% and consider the significant use of leverage.

What I want to propose in this article is an alternative way of achieving returns similar to what multi-strategy funds offer or perhaps even better while not compromising too much in the areas of risk management and diversification. And all of this at a fraction of cost.

There are few possible ways to achieve this, and I will outline one of them, in the equities space. It consists of two steps.

First, one needs to return to one of the most successful hedge fund managers of all time: George Soros.

More specifically, one has to understand why his book is called “Alchemy of Finance” and not “Science of Finance”.

There is one very important point Soros makes in the book which is overlooked compared to the main focus on reflexivity paradox.

He concludes that at the end of the day, it is impossible to succeed in markets with a purely scientific approach.

Soros explains that in the course of his investment activities, he discovered that financial markets operate on a principle that is somehow akin to the scientific method. Making an investment decision is like formulating

a scientific hypothesis and submitting it to a practical test.

According to him, most market participants do not view markets in this light. That means that they do not know what hypotheses are being tested; it also means that most of the hypotheses that are submitted to market testing are quite banal. Usually, they amount to nothing more than the assertion that a particular stock is going to outperform market averages.

So, he views investing and financial markets as a laboratory for testing hypotheses but not necessarily strictly scientific ones. Therefore, he says that successful investing is a kind of alchemy.

Considering this, there is an important question one should ask himself. If this “laboratory” is not strictly a scientific one and if the hypotheses themselves are not strictly scientific ones, then how does one goes about formulating them?

It is a million-dollar question and, in my view, a major and very important question that Soros does not answer. You can read my book Investing: From Science To Art in order to get an answer to this.

But for the purpose of replicating multi-strategy hedge funds performance, it is enough to understand that portfolio should be diversified not only by risk-return profile, not only by industry, not only by factors, but also by the hypotheses being tested.

The second step is to understand that the hypotheses being tested can be related to companies or they can be related to market participants. Often it is a mix of both. And one has to come up with an approach to identify different hypotheses.

For example, one position might be a spin-off situation (with the hypothesis being tested is that of upcoming revaluation of the company by market participants). Or the position might be a calculated gamble on company being bought out (with the hypothesis being tested is that of possible upcoming buyout offer).

In these cases, investors test the hypotheses related to market participants or market’s perception of a given stock or company.

The second type of hypotheses are the ones which are related to company itself. For example, one position might be a play on activist shareholder involvement (with the hypothesis being tested is that of expected corporate reform). Or the position might be in shares of a company belonging to a problematic sector (with the hypothesis being tested is that this company specifically is less exposed to the industry dynamics and will perform better).

In the event-driven equities space, for example, there are many types of situations of both types. And the number of these hypotheses available in the market is large enough to construct and manage a diversified portfolio.

While a major part of multi-strategy hedge funds is still built around industry-focused teams, adding a totally different layer of diversification will allow you to capture a lot of different investment opportunities.

I believe that by combining this diversification by different types of the hypotheses being tested with all the classical aspects of diversification one can achieve excellent results and even beat multi-strategy hedge funds at a fraction of cost.

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